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STAFF DATA
ON
SECTIONS 462 AND 452
OF THE
INTERNAL REVENUE CODE OF 1954

PREPARED FOR THE
COMMITTEE ON FINANCE
OF THE U. S. SENATE

BY THE
STAFF OF THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION



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STAFF DATA ON SECTIONS 452 AND 462 OF THE INTERNAL REVENUE CODE OF 1954

PART I. GENERAL SUMMARY OF H. R. 4725

A. DISCUSSION OF PRINCIPLES OF SECTIONS 452 AND 462

Section 462 of the Internal Revenue code of 1954 specifically in the statute permitted taxpayers to deduct currently certain estimated future expenses related to current income. To illustrate the effect of this consider an appliance store that had outstanding, at the end of 1954, guarantees on its products which could reasonably be estimated to involve probable future costs of \$1,000. This could be deducted in 1954 under section 462. During the year the same store may have fulfilled guarantees which were outstanding at the end of 1953 at a cost of \$1,000. Since these latter expenditures had not previously been deducted, they also could be deducted in 1954. This is the so-called double deduction and it was specifically provided for in section 462.

Section 452 specifically in the statute permitted taxpayers to defer the reporting of prepaid income. Section 452 applied to income currently received but involving a performance liability on the taxpayer in the future. The income would be taxed as it was earned but it could not be spread over more than 5 future years. The appliance store described above, instead of offering guarantees might have sold service contracts on their appliances. At the end of both 1953 and 1954 the amount of income allocable to the remaining unexpired time of outstanding contracts may have been \$1,000. The taxpayer would have reported \$1,000 under the old law as income in 1953; section 452 permitted the postponement in 1954 of the corresponding \$1,000. Thus, even if the firm's business were constant, its taxable income would be reduced for 1954. This result is the same as the result of the so-called double deduction.

In the public discussion considerable importance has been attached to the "illustrative items" given in the committee as items for which these sections were clearly intended. For section 462 these were: product guarantees, cash and quantity discounts, freight allowances, vacation pay, sales returns and allowances, and certain liabilities for self-insured injury and damage claims. The illustrations given in the committee report for section 452 were prepaid rents, payments on service contracts, sales of coupons, tickets and tokens redeemable in the future, club dues, and warehouse fees.

B. SUMMARY OF SECTION 462

Under the 1939 law deductions for expenses and losses incurred by a taxpayer could be taken only when all events had occurred which fixed the fact and the amount of the taxpayer's liability.

The 1954 Code permits an accrual-basis taxpayer to deduct reasonable additions (in the discretion of the Secretary or his delegate) to reserves for various types of estimated expenses. The probable future expenses must be related to income taxed during the current year or to income of preceding years for which reserves for estimated expenses have been established, must be such as would be allowable deductions, and must be such as the Secretary or his delegate is satisfied can be estimated with reasonable accuracy. A reserve is to be considered reasonably estimated when it is based on reliable data or statistical experience of the taxpayer or of others in similar circumstances. Reserves for general contingencies, indefinite future losses, or for amounts in litigation do not fall in this category.

At the end of each year these reserves are to be adjusted to reflect the best estimate currently available; any amount by which a reserve is found to be excessive is to be taken into account in the year of determination.

Estimated expenses do not include any deduction attributable to income reported in a taxable year beginning before the benefits of this provision were elected, to deductions with respect to prepaid income which the taxpayer has elected to defer, or to deductions for bad debts.

A taxpayer, without the consent of the Treasury Department, may elect to establish reserves for estimated expenses for his first year beginning after December 31, 1953, in which he has such expenses. With the consent of the Treasury Department the taxpayer can make this election at any other time. Expenses incurred in 1954 and subsequent years which pertain to the income of taxable years preceding the first year of an election under this provision may be deducted as though this provision had not been enacted.

C. SUMMARY OF SECTION 452

Under the 1939 Code payments received in advance for the use of property in future years, or for services to be rendered in future years, were includible in the income of the recipient in the year they were received. This was true regardless of the taxpayer's method of accounting.

The 1954 Code permits accrual-basis taxpayers to defer the reporting of advance payments as income until the year, or years, in which, under the taxpayer's regular method of accounting, the income is earned if the services are to be performed, the goods are to be furnished, or the use of property is to be allowed, within 5 years after the year in which the income is received. If the liability to perform services or supply property does not in fact end within that 5-year period the income must nevertheless be allocated to that period unless the Secretary or his delegate consents to a different allocation.

Where amounts are received in advance and are not to be earned within the 5-year period, taxpayers who have so elected are to take the prepayments into account ratably over the period of the taxable year of receipt and the 5 succeeding taxable years. With the consent of the Secretary or his delegate, however, the taxpayer may allocate the income in another manner.

Amounts received in advance which are to be earned over an indefinite period (e. g., tickets or tokens redeemable indefinitely) may be

classified in part as income to be earned over a short period, to be allocated to income in the year or years proper under the taxpayer's method of accounting, and in part as income to be earned over a period in excess of 5 years to be allocated ratably to the year of receipt and the succeeding 5 years, on the basis of a reasonable estimate, in accordance with regulations prescribed by the Secretary or his delegate unless the Secretary or his delegate consent to a different allocation.

Where a taxpayer dies or where, for any other reason, the liability with respect to the deferred income ceases, the prepayments not previously reported as income become taxable in the year in which such an event occurs.

The election provided in this provision is available only with respect to advance payments received by a taxpayer in a taxable year beginning after December 31, 1953. If the election is made the treatment explained above must be applied to all income received in advance, during the year of the election and subsequent years, in connection with that trade or business, except that income to be earned within 12 months may be treated as income of the year in which it was received.

D. SUMMARY OF THE BILL

H. R. 4725 repeals both sections 452 and 462 retroactively to their inception. The bill contains provisions to alleviate certain of the difficulties caused taxpayers by this repeal. Essentially three such difficulties are dealt with. It is provided that if a taxpayer pays by September 15 additional taxes required by this repeal, no interest shall be charged. Secondly, it is provided that no penalties or additions to tax (including those with respect to estimated tax) are to be imposed where the penalties or additions are attributable solely to the repeal of these sections and are imposed with respect to taxes paid or due on or before September 15. Finally, it is provided that the time for qualifying for any deductions that are affected by repeal will be extended to September 15. An illustration of this last problem would be contributions to a profit-sharing trust which are geared to taxable income. Repeal would result in an increased contribution being required, and if made before September 15 it could be deducted from 1954 income.

The committee report on H. R. 4725 discusses two problems raised by repeal which are not treated in the bill. It is stated that there is no intention of disturbing prior law as it affected permissible accrual accounting provisions for tax purposes, including the treatment of prepaid newspaper subscriptions. On the question of accrual of vacation pay, the Treasury indicated to the House Ways and Means Committee that the provisions of its rulings under the 1939 Code which permitted accrual of vacation pay under specified conditions will not be revoked for any taxable year ending prior to January 1, 1956. These problems are discussed further below.

PART II. EFFECT OF REPEAL—RESTORATION OF PRIOR LAW.

Repeal of sections 452 and 462 retroactively to the date of their enactment as part of the 1954 Code will have the effect of restoring prior law in these areas.

Under prior law, there were no specific statutory provisions dealing with reserves for estimated expenses (other than the reserve for bad

debts) or dealing with the deferral of prepaid income. This area was covered under prior law in the general accounting provisions contained in sections 41, 42, and 43 of the 1939 Code. Section 41 set forth the general rule that income should be computed on the basis employed by the taxpayer in keeping his books, provided that that method clearly reflected income. Section 42 provided a general rule that income should be included by the taxpayer in gross income for the taxable year in which received unless under the taxpayer's method of accounting it was to be properly accounted for as of a different period. Section 43 provided that deductions and credits should be taken in the taxable year in which "paid or accrued" or "paid or incurred" depending upon the method of accounting of the taxpayer, unless required to be taken as of a different period in order to clearly reflect income.

Under the above rules of prior law, there existed a great deal of uncertainty and confusion in the treatment of certain items involved in sections 452 and 462. These items, which involve a large part of the revenue loss arising under those sections, are vacation pay under section 462 and prepaid newspaper and periodical subscriptions under section 452.

A. ACCRUAL OF VACATION PAY

Under prior law, the Treasury practice frequently permitted the "doubling up" effect in the case of taxpayers who switched to accruing vacation pay instead of deducting vacation payments when actually made. Thus, under its rulings, the Treasury permitted taxpayers to switch to accruing vacation pay and to get a deduction in the year of change for both the amount of vacation payments actually made for that year and the vacation pay which properly would be required to be paid in the next year under the employer's vacation plan or union contract. The vacation payments to be made in the following year were treated as an accrued liability at the close of the taxable year if all elements fixing the employees' entitlement to vacation had occurred at the end of the taxable year. Under these circumstances, the accrual was permitted even though an individual employee's right to receive the vacation in the following year might be lost if he left the employment before the time for taking his vacation.

When the Ways and Means Committee considered the repeal of sections 452 and 462, the Secretary of the Treasury assured the committee by letter that taxpayers would be permitted to accrue vacation pay, if they came within the prior Treasury rulings, for any taxable year which ended on or before December 31, 1955. Thus, the repeal of section 462 will permit a continuance of the "doubling up" benefit of vacation pay accruals for taxable years 1954 and 1955 if the vacation pay first becomes accruable in those years within the Treasury rulings. If the Treasury does withdraw its rulings for 1956 and subsequent years and Congress takes no action other than the repeal of section 462, it would appear that most taxpayers who previously had been accruing vacation pay under these rulings would be faced with the possibility of having no deductions for vacation pay in 1956.

(For a discussion of the history of Treasury rulings and court decisions on vacation pay accruals see appendix A.)

B. PREPAID NEWSPAPER AND PERIODICAL SUBSCRIPTIONS

The status of the 1939 Code of prepaid newspaper and periodical subscriptions is in the same state of confusion and uncertainty as that of vacation pay accruals.

In I. T. 3369 (1940-1 C. B. 46), the Treasury ruled that publishers of periodicals on the accrual basis, who had over a period of years consistently followed the practice of reporting periodical subscriptions for the year of the subscription period rather than for the year of receipt, would be permitted to continue to file their tax returns on that basis and would not be required to change to any other basis. In such cases, however, the ruling required that the publisher also spread over the subscription period the expenses incurred in the year in which the subscriptions were obtained which were applicable thereto.

With the enactment by the Revenue Act of 1950 of section 23 (bb) of the 1939 Code, relating to deductibility of circulation expenditures, the Treasury has taken the position that circulation expenditures which are attributable to prepaid subscriptions may be deducted in the year when incurred (rather than the year in which the income to which they relate is reported), unless the taxpayer elects to capitalize them.

Representatives of the newspaper and magazine publishers have stated in the public hearings on H. R. 4725 that many of these publishers are now reporting their prepaid subscriptions on the deferral method. However, some newspaper and magazine publishers either have not changed to that method or have currently before the Internal Revenue Service applications for rulings for permission to change. One witness appearing before your committee stated that some of the rulings on prepaid subscriptions which had been granted in recent years have permitted the taxpayer to defer prepaid subscription income even though the taxpayer had not reported his income for tax purposes in the past on that basis. These rulings required, however, that the transition benefit be spread over 10 years.

The status of prepaid subscription income if section 452 is repealed is also rendered uncertain by a recent circuit court decision in *Beacon Publishing Co.* (C. C. A. 10th, Jan. 3, 1955). The court of appeals held that the deferral of prepaid subscription income was proper under the accrual method of accounting. In that case, the taxpayer prior to 1943 had reported its prepaid newspaper subscriptions as income for the year in which received. In 1944 the newspaper switched to deferring prepaid subscription income to the year to which the subscriptions related. The court held that the taxpayer's action was proper under the accrual method of accounting. It stated that if the taxpayer were compelled to report the prepaid subscriptions as income for the year in which received, it would be on a cash basis of accounting rather than properly on an accrual basis. It, therefore, held that the taxpayer was not required to obtain the consent of the Commissioner to change its method of accounting for the year involved, since the taxpayer was only correcting a past error.

The Government has not appealed the *Beacon Publishing Co.* decision, and the Secretary of the Treasury indicated in his letter to the

Ways and Means Committee on H. R. 4725 that repeal of section 452 under that bill would not be considered by the Treasury as either an acceptance or a rejection by the Congress of the court's decision in *Beacon Publishing Co.* The status of the law in this area would thus appear to remain confused and uncertain until legislative action by the Congress.

If the ruling of the *Beacon Publishing Co.* case is followed generally with respect to items of prepaid income, any item of prepaid income may be deferred until the year to which the income relates. There would be no restriction, as there is under section 452, by which the maximum deferment of prepaid income is for the year of receipt and the 5 succeeding taxable years.

C. OTHER AREAS OF UNCERTAINTY

In addition to the uncertainty in treatment of vacation pay accruals and prepaid subscription income under the 1939 Code, doubt was cast upon the treatment under the accrual method of certain future expenses by a recent circuit court decision. In *Pacific Grape Products* (C. C. A. 9th, Feb. 10, 1955), the circuit court held that certain freight and shipping expenses (such as labeling and casing expenses) to be incurred subsequent to the end of the taxable year could be accrued for tax purposes as of December 31 of the taxable year since the expenses were either precisely known or determinable with extreme accuracy as of that date.

An extension of the principles laid down in the *Pacific Grape Products* case might well lead the courts in the future to permit as accruals items of future expenses attributable to income of the taxable year where the amount of the future expenses could be determined with a high degree of accuracy. If this principle were generally adopted, estimated expenses in many instances would be deductible under the accrual method of accounting despite the repeal of section 462 of the 1954 Code. In the transition year this might involve a doubling up of deductions for such items.

PART III. SUMMARY OF STAFF ALTERNATIVE

A. SECTION 462

1. Denial of double deduction.

In the year of transition taxpayers would be denied the right to double up their deductions. They would be permitted to deduct estimated and actual expenses related to transactions in the year of transition but not expenses related to transactions of earlier years.

Example.—The manner in which this denial of double deductions works can be illustrated by a taxpayer who sells a product with a guaranty of satisfactory operation for a period of 2 years. Assume the company's sales amounted to \$10,000 in 1952, \$11,000 in 1953, and \$13,000 in 1954. Also assume that on the average 10 percent of the

sales were required to satisfy the guaranty. If these expenses were spread evenly, they would be incurred as follows:

Year of sale	Total expenses	Year expense is incurred				
		1952	1953	1954	1955	1956
1952.....	\$1,000	\$250	\$500	*\$250	-----	-----
1953.....	1,100	-----	275	*\$550	*\$275	-----
1954.....	1,300	-----	-----	325	650	\$325

Total expenses incurred in 1954, \$1,125.

This taxpayer would have been able to deduct \$1,125 in expenses in 1954 if he had not adopted the reserve method. If he adopted the reserve method under the staff alternative he could deduct \$1,300, the expenses attributable to 1954 sales to be incurred in that and subsequent years. The deduction to be deferred in the manner described in No. 2 below is the reserve the taxpayer would have had if he had been on this system prior to 1954; namely, the expenses still to be incurred on January 1, 1954, with respect to 1952 and 1953 sales. This is \$1,075 in this example, or the sum of \$250, \$550, and \$275 the starred items shown in the table above. In years after the transition year the taxpayer would continue to deduct the reasonable addition to his reserve; namely the equivalent of the \$1,300 in 1954.

2. Carryover of denied deduction

The deduction denied the taxpayer in the year of transition (the \$1,075 or the sum of \$250, \$550, and \$275 in the above example) would be available to the taxpayer at any time to the extent his reserve at the end of any year was less than the unused portion of this deduction. To the extent not previously used up the deduction also would be available upon the death of a sole proprietor or partner or upon a complete taxable liquidation of a corporation.

Example.—If the company referred to above had a decline in sales in 1955 and as a result had a reserve of only \$800 at the end of that year, it could deduct for tax purposes, along with its normal addition to its reserve, the excess of the \$1,075 over the \$800, or \$275. This would leave \$800 of the denied deduction available for future years. If in 1956, because of decreased costs resulting from improvements in the product sold, it had a reserve at the end of the year of only \$300, then \$500 of the \$800 of unused deduction could also be taken. If at the end of a subsequent year no reserve was required, the remaining \$300 of deduction could then be taken.

3. Limited expense categories

Section 462 would be available only in the case of the following expense categories:

- (a) Product warranties and service contracts;
- (b) Freight allowances;
- (c) Cash and quantity discounts;
- (d) Vacation pay; and
- (e) Repayment of commissions.

The rules outlined under this alternative would apply separately to each of these categories.

4. Six-year requirement

Additions to a reserve would be made only for those expenses expected to be incurred in the taxable year or 5 succeeding years.

5. Reserve to be reflected on books

The reserve method would have to be reflected on the books of account and published statements of the taxpayer except in cases, like public utilities, where regulatory bodies may have their own prescribed forms for public statements.

6. Consent required after 1955

Once a taxpayer elects section 462 treatment he could not void this election except with approval of the Commissioner of Internal Revenue. He could elect this treatment without consent in 1954 or 1955, but to obtain this treatment in subsequent years he must obtain the Commissioner's approval.

7. Not to disturb taxpayers already on reserve system

A provision would be added indicating that nothing in section 462 is intended to deny taxpayers any rights they may have to establish reserves under other provisions of law. Thus, the enactment of this provision would not be construed to effect established practice under prior law which had been consistently followed by the taxpayer and approved by the Internal Revenue Service under rulings or otherwise.

B. SECTION 452

1. Limited income categories

The benefit of the section would be limited to prepaid income from—

(a) Newspaper and periodical subscriptions;

(b) Rents; and

(c) Dues and fees of service associations not organized for profit.

The rules outlined under this alternative would apply separately to each of these income categories.

2. Expenses attributable to income

Direct expenses attributable to production of income deferred by this provision would be allowed as deductions only in the year in which the income to which they relate is reported.

3. Deferral to be reflected on books

The deferred income treatment would have to be reflected on the books of account and published statements of the taxpayer except in cases, like public utilities, where regulatory bodies may have their own prescribed forms for public statements.

4. Consent required after 1955

Once a taxpayer elects section 452 treatment he could not void this election except with the approval of the Commissioner of Internal Revenue. He could elect this treatment without consent in 1954 or 1955 but to obtain this treatment in subsequent years he must obtain the Commissioner's approval.

5. Not to disturb taxpayers already deferring income

A provision would be added indicating that nothing in section 452 is intended to deny taxpayers any rights they may have to defer income under other provisions of law. Thus, the enactment of this provision would not be construed to affect established practice under prior law which had been approved by the Internal Revenue Service under rulings or otherwise.

PART IV. EXPLANATION OF STAFF ALTERNATIVE

The Secretary of the Treasury in his testimony before the committee urged retroactive repeal of sections 452 and 462 of the 1954 code on two primary grounds. His first reason was that the statute is being construed to include items that were not intended to be included. His second reason was that the revenue loss appears to be substantially in excess of the loss originally estimated. He stated, however, his complete agreement with the basic purpose of these sections—to conform tax accounting with sound accounting principles.

Taxpayers who have appeared before the committee have unanimously recommended retention of these sections in the code even though some modification may be necessary to meet the Treasury's objections.

The staff of the joint committee has studied a number of proposals designed to retain the basic principles of sections 452 and 462 but which would reduce the revenue loss thereunder. As a result of its studies, the staff has worked out alternatives which it believes will retain the basic purpose of the sections and at the same time meet the Treasury's objections. The alternatives have also been revised in one respect to meet objections raised in the committee's hearings.

A. SECTION 462

Section 462, as it presently appears in the 1954 code, permits a taxpayer in the year he converts from an ordinary accrual system to a reserve accrual system to deduct both his additions to the reserve for estimated expenses and also similar expenses paid or incurred during that year. It is this taking of two similar sets of deductions in the same year which is the major objection which has been raised to section 462 and which accounts for the unexpectedly large revenue loss.

This doubling up of deductions in the year of conversion or transition can be illustrated by a 2-year product guarantee on a television set. Assume that company A sold television sets which its previous experience indicated required expenditures of \$10 per unit on the average to keep the set in proper working condition during the period of the 2-year guaranty. Thus, one of these television sets sold in 1953 could be expected to require servicing in 1954 which would cost company A \$10. This \$10 deduction is an ordinary business expense and would be allowed in 1954 even though the taxpayer had converted to the reserve method as of the first of 1954, since this expense was attributable to a sale made prior to that time. At the same time section 462 would permit company A to also take a deduction in 1954 for a sale in that year which could be expected to result in \$10 of ex-

pense in 1955. This is the doubling up of deductions which has caused the problems in connection with section 462.

The alternative worked out by the staff avoids this doubling up of deductions in the year of transition by saying that the taxpayer in that year can deduct the second \$10 amount, the amount which represents the addition to the reserve, but cannot take a deduction for the first \$10 amount referred to in the example. The first \$10 in the example is the amount actually paid in the transition year with respect to sales of prior years. This \$10 deduction denied to the taxpayer in the year he converts to the reserve method is not, however, denied to him for all time.

Because it is sometimes difficult for taxpayers to segregate their expenses by the year in which the transactions first arose, the alternative provides that, instead of carrying over the actual transition year expenses attributable to income of prior years, the taxpayer would carry over the amount of the reserve he would have had as of the first of the transition year had he previously been on the reserve method. In the example presented above this would be exactly the same as the \$10 of expense actually paid during 1954. In other cases, however, it might be somewhat larger because of expenses which might be paid in 1955, for example, with respect to transactions entered into in 1953 or earlier years.

A taxpayer who adopts the reserve method of accounting for estimated expenses is assured under the staff alternative that he will at least be no worse off than he would have been had he not adopted such a method of accounting. This represents a modification of the plan originally presented to the committee to meet objections raised in its hearings. Under the revised alternative this assurance is provided by allowing the taxpayer this previously denied deduction, or a portion of it, at any time his reserve for estimated expenses is less than the unused portion of this denied deduction. In the example of the television-product warranty, this would mean that any time the taxpayer's reserve was less than \$10, which was the amount of the denied deduction, he could increase the deduction he could take for tax purposes to this amount. For example, if in 1956 his reserve amounted to only \$8, he could in that year, when deducting the addition to the reserve, also deduct \$2 to bring his total deductions up to \$10. This would reduce the amount of the denied deduction still available for future use to \$8. If in 1957 his reserve was \$5, he could again deduct not only his addition to his reserve but also \$3 more of the previously denied deduction, reducing the amount of this deduction still to be taken to \$5. If in the following year his reserve was zero at the end of the year he could use up the remaining denied deduction of \$5. After that time, however, only an amount equal to the addition to the reserve would be allowed as a deduction for tax purposes.

To supplement this it would also be provided that the denied deduction would be available to the taxpayer in the year he died, in the case of a sole proprietor or partner, or in the year of complete taxable liquidation in the case of a corporation.

The method outlined above would mean that there would be no doubling up of deductions for taxpayers electing the reserve method provided by section 462. At the same time assurance is given the taxpayer electing this reserve method that at least he would be no worse off than he would have been had he not elected this method.

For the taxpayer with a growing business, the reserve system always provides more favorable treatment than the deduction of expenses as they are incurred. This is true because the expenses related to the current year's income are larger in a growing business than the expenses not yet incurred which are related to years prior to the transition year. For a concern with a constant level of business the deductions under the reserve system, namely the expenses attributable to the current year's income, would be the same as the deduction of expenses incurred in the current year but attributable to income of years prior to the transition year. Only in the case of the declining business, or at least a business with declining expenses, is the reserve system less attractive to the taxpayer. In such a case the expenses attributable to the current year's income which he deducts are less than the expense deduction foregone, namely, the expenses attributable to years prior to the transition year. The alternative worked out by the staff prevents any hardship, however, since, by permitting the deduction of at least as much as the amount denied in the transition year, so long as this amount is not used up, it in effect permits the taxpayer to use the reserve or nonreserve method, depending on which is the more favorable.

In general the alternative worked out by the staff provides that the taxpayer is to remain on a nonreserve method for years prior to the transition year and a reserve method in the transition and subsequent years.

On the other hand, the present section 462 in effect allows the taxpayer (except for differences in tax rates) to recompute his taxes as if he had always been on the reserve method, but does so by allowing two sets of deductions in the transition year. The principle involved in requiring the taxpayer to spread one of these deductions over a 10-year period, the so-called 10-year stretchout advocated by some of the witnesses before this committee, is the same as that in the present section 462; the only difference is the fact that the adjustment is made more slowly.

Another major objection to the present section 462 is the uncertainty of its scope. Secretary Humphrey referred to this problem in suggesting that problems might arise if taxpayers are allowed to set up reserves for such items as repair and maintenance expense. The proposed regulations issued this last January provide that such expenses are not included in section 462, although the Treasury apparently is not certain that this aspect of the proposed regulations would be upheld by the courts.

The alternative the staff has worked out meets this problem by limiting the application of section 462 to certain limited types of expenses and provides that a taxpayer may elect section 462 treatment for any of these categories. This differs from present section 462 which requires the taxpayer to set up reserves for all proper types of estimated expenses. These categories would be:

- (1) Product warranties or guaranties and service contracts (such as the television warranty in the example or a contract to keep the TV set in working order where it is purchased separately from the TV set itself);

- (2) Freight or shipping allowances (when the services are performed by other than the taxpayer);

- (3) Cash and quantity discounts;

- (4) Vacation pay; and
- (5) Repayment of commissions (such as repayment of insurance commissions by salesmen where the policy is subsequently canceled).

By limiting the provision to a few specific categories, like those listed above, it would appear that most of the types of expenses for which the provision was initially designed can be provided for without taxpayers being able to claim expenses which may involve problems which at present cannot be fully appreciated.

To follow this procedure of providing for specific types of expenses is in accord with previously established policy. The code has long provided for a reserve for bad debts which in reality is the same in character as the reserve for expenses provided for in section 462. Probably the problem of estimating the size of the bad-debt deduction, however, is somewhat more difficult than would be likely in the case of the types of expenses listed above.

Witnesses before the committee have requested the extension of the categories listed in the staff alternative: specifically, requests have been made to include sales returns and allowances, and freight damage and personal injury claims in the case of common carriers. The logic for including such items would appear as good as items presently included and both categories were in fact initially in the staff alternative. Sales returns and allowances was omitted because it was believed that definitional problems would be presented by such a category and that it, therefore, should be left for further study. In the case of freight damage and personal-injury claims, it appeared somewhat inequitable to limit this category to common carriers but the extent and type of the expenses involved appeared uncertain if this were not done. Therefore, it also was omitted in the suggested alternative statutory provision.

Under the staff alternative additions to a reserve for estimated expenses can only take into account expenses expected to be incurred in the taxable year or the next succeeding 5 years. This provision should be of help in meeting the problem with which Secretary Humphrey expressed concern; namely, the problem of determining the proper size of the addition to the reserve. This means that the taxpayer may not take into account expenses which are likely to be incurred in the indefinite future. Moreover, the requirement limiting the application of the provision to the specifically described types of expenses also should go far in meeting the problem presented by the Secretary. It should also be pointed out that a provision already in section 462 provides that an addition to a reserve can only be taken with respect to expenses which the Secretary or his delegate is satisfied can be estimated with reasonable accuracy. This provision, of course, would be continued.

Another feature of the alternative would require the reserve method to be reflected on the books of account and published statements of taxpayers electing section 462, except in cases like public utilities where regulatory bodies have their own prescribed forms for public statements. This is in accord with the proposed regulations issued by the Treasury under the present statute. This feature of the regulations has been objected to by some taxpayers, however, on the grounds that authority for this requirement did not exist in the statute.

Under the staff alternative a provision would also indicate that nothing in the new section 462 would be intended to deny taxpayers any rights they had to establish reserves under other provisions of law. Thus, the enactment of this provision would not be construed to affect established practice under prior law which has been approved by the Internal Revenue Service under rulings or otherwise. This should prevent the section from injuring taxpayers who have obtained rulings either public or private entitling them to estimate expenses.

B. SECTION 452

The revision of present section 452 under the alternative worked out by the staff is much less drastic than that already described in the case of section 462. Here the problem is not so much the revenue involved in the present provision but rather the revenue which might be involved in this provision if section 462 were to be repealed and this section left in the statutes.

The Treasury has indicated that its chief reason for advocating the repeal of section 452 is the fear that taxpayers in many cases would be able to convert transactions which otherwise would qualify under section 462 to a somewhat different form in order to qualify under section 452. In the case of the television-product guaranty, for example, it would appear that to the extent companies are willing to sell their service contracts separately from the television set the income attributable to such contracts would properly be considered as prepaid income and eligible for the tax treatment provided by the present section 452. Also the insurance salesmen have contended that their commission income in some cases is related to the services yet to be performed with respect to the insurance policies and, therefore, should be eligible for section 452 treatment rather than giving rise to estimated expenses coming under section 462.

The prepaid-income provision differs from the provision for reserves for estimated expenses in that the earning of the income itself is presumed to occur in large measure at some future time. The estimated expense, on the other hand, involves cases where the income in large measure is earned in the current taxable year but some expenses relating to that income are yet to be incurred. The major distinction between these two provisions is that where the expense-reserve provision applies, most of the income is earned in the current year, with some of the expenses being incurred subsequently. In the case of the prepaid-income provision, most of the income is earned subsequently. Although some of the related expenses may be incurred in the present year.

In order to prevent taxpayers from shifting from section 462 to section 452, the alternative worked out by the staff in the case of section 452 limits the benefits of this provision to the following types of prepaid income:

- (1) Newspaper and periodical subscriptions;
- (2) Rents; and
- (3) Dues and fees of service associations not organized for profit.

Limiting the types of prepaid income eligible for this provision to these categories will make it impossible for taxpayers to convert their

transactions from a form in which they qualify under section 452 rather than under section 462.

Testimony before this committee suggested that TV service contracts should be included under section 452 instead of 462. The staff alternative would not cover service-contract income under section 452, primarily because of the ease with which a product guaranty can be converted into a service contract. This would undeniably be true as to future contracts even though it may not necessarily be true under existing contracts. The combination of the service-contract income, together with the income attributable to the converted-product guaranties, would substantially increase the revenue cost of this provision since the equivalent of a doubling up of deductions is allowed under section 452. This doubling up effect makes little difference in the case of subscription income because most such income has previously been converted to such a basis, and the benefit already has been taken. The rental income generally is in isolated transactions and the service association dues involve only organizations which pay no profits out to their members.

The fact that TV service-contract income may enjoy substantial advantages under the alternative section 462 also should not be overlooked. To the extent that such income is offset by expenses and to the extent of growth in the future, the same advantage would be enjoyed under section 462. Only to the extent of the profit on the service-contract income and to the extent the income represents past transactions would the TV service-contract income be denied benefits they might obtain from section 452. Moreover, the prospect of color television in the near future would appear to assure the growth factor for these service contracts.

Another objection to the present section 452 raised by the Treasury in the executive sessions before the House Ways and Means Committee was the fact that although section 452 provided for the deferral of prepaid income, it did not also provide for the deferral of expenses incurred in the present year which are related to such income. As the witness for the American Institute of Accountants pointed out in testimony before this committee in the case of prepaid rents certain expenses attributable to the prepaid income, even before the 1954 Code, had to be spread over the period in which the income was earned. This is not true, however, in the case of all expenses of prepaid rents and is not generally true in the case of expenses incurred in obtaining other types of prepaid income.

The alternative worked out by the staff requires direct expenses attributable to the prepaid income to be deferred in the same manner as the prepaid income itself.

The remaining changes under the alternative worked out by the staff in section 452 are relatively minor in character. As in the case of section 462, the alternative would provide that the deferred income treatment would have to be reflected on the books of account and published statement of the taxpayers except in cases, like public utilities, where regulatory bodies may have their own prescribed forms for public statements.

Also, a provision would be added indicating that nothing in section 452 is intended to deny taxpayers any rights they previously had to defer income. Thus, taxpayers who have deferred prepaid income past, whether or not of one of the three categories listed and whether

or not they have been required to defer expenses attributable to such income would be able to continue doing so if there was any indication of previous approval by the Internal Revenue Service. The modification permitting taxpayers to continue to not spread expenses related to deferred income appears necessary in view of the Treasury's practice in the past of issuing rulings with respect to subscription income permitting the deferral of the income but not requiring the deferral of the expenses related to the income.

PART V. ORIGINS OF SECTIONS 452 AND 462

In its questionnaire addressed to numerous taxpayer groups and to taxpayers generally in the summer of 1952, the staff of the Joint Committee on Internal Revenue Taxation invited technical suggestions for improvement of the internal revenue laws.

In response to this inquiry, the American Institute of Accountants (hereinafter referred to as the accountants) submitted to the Congress and to the joint committee staff its recommendations for amendments of the Federal tax laws. These recommendations were submitted in printed form by the accountants in January 1953 and were discussed with representatives of the accountants' tax committee by the joint committee staff at a meeting held early in 1953.

A principal proposal of the accountants was that accounting for income-tax purposes should be brought into closer conformity with generally accepted accounting principles in at least four specific areas. Two of these were the treatment of prepaid income and the treatment of estimated expenses and losses.

Similar recommendations for bringing tax accounting into conformity with generally accepted principles for business purposes were also made by other taxpayer groups. (See preliminary digest of suggestions for Internal Revenue revision submitted to the Joint Committee on Internal Revenue Taxation dated April 21, 1953, with reference to recommendations made by the Commerce and Industry Association, Federal Tax Forum, National Association of Manufacturers, American Telephone & Telegraph Co., and Georgia Society of Certified Public Accountants.) Similar proposals were also made to the Ways and Means Committee during its hearings on tax revision in the summer of 1953 (see vol. I, pp. 598-658).

The American Law Institute in its tentative draft No. 6 of a comprehensive Federal income tax statute included specific proposals for the treatment of prepaid income and reserves for estimated expenses (section X312 (b) and (c)).

A. STAFFS' CONSIDERATION OF PROPOSALS

On the basis of the above-suggested amendments, a report by members of the Treasury staff and joint committee staff was prepared on changes in the accounting provisions of the Internal Revenue Code.

With regard to prepaid income, this report summarized the proposals of the accountants and the American Law Institute. It indicated that there were already in existence some precedents under the 1939 Code for deferring the reporting of income beyond the year of actual receipt—for example, the long-term contract method of accounting permitted under regulations and the provisions for spread-

ing receipts from certain magazine subscriptions permitted under certain Treasury rulings.

In connection with the treatment of estimated expenses, the staffs' report also analyzed the American Law Institute proposal and the accountants' proposal. It indicated that limited precedents existed for the allowance of deductions for certain estimated expenses and losses. For example, the 1939 Code provided for the deduction of a reasonable annual addition to bad debt reserves. Similarly, the regulations permitted deduction of estimated cost of redemption trading stamps. It was suggested that the principal argument against the proposal for setting up allowable reserves for estimated expenses would be the tendency to encourage controversy and litigation both as to the types of allowable reserves and as to the amount of the addition to the reserves. It was suggested that the area of controversy could be restricted by giving the Secretary relatively broad regulatory authority in the field. While not minimizing the administrative difficulties that might be involved, the report stated that adoption of the proposal would do much to bring tax accounting more nearly into line with commercial accounting and would result in more accurate computation of the true net income attributable to each year's operations.

On the basis of the recommendations made by the American Law Institute and the accountants and the analysis of the Treasury and the joint committee staff, it was determined to make joint recommendations to the Ways and Means Committee for changes in the accounting provisions of the Internal Revenue Code which would have the effect of more nearly alining tax accounting with generally accepted accounting principles. On the basis of this decision, representatives of the Treasury Department and the joint committee staff and the Internal Revenue Service met with the House legislative counsel's office to draft proposals which would carry out the suggested amendments. This resulted in section 452 and 462 of the House bill. Both of these provisions adopted a number of restrictive measures designed to protect the revenue. For example, in the treatment of prepaid income the unlimited spread of prepaid income proposed by the accountants was not adopted. Instead, provision was made that where the prepaid income was earned over a period of more than 5 years, the period of spreading was limited to the taxable year and the 5 succeeding years. Similarly it was provided that where the taxpayer's liability ceased, such as by reason of death or dissolution of the taxpayer, any prepaid income not previously reported was to be includible in the taxpayer's income at that time. An effort also was made to limit the scope of income to be so treated by requiring that it be directly attributable to a liability extending beyond the close of the taxable year in which the amount was received.

In the case of reserves for estimated expenses similar restrictive provisions were included for the purpose of protecting the revenue. For example, it was provided that the estimated expense would have to be of a type which the Secretary or his delegate was satisfied could be estimated with reasonable accuracy. Also, it was provided that where the reserve became excessive, the excessive amount should be taken into income at that time.

In the treatment of both prepaid income and reserves for estimated expenses, it was provided that the election to adopt either method had

to be made for the first taxable year beginning after December 31, 1953, in which the taxpayer had prepaid income or estimated future expenses, if the election was to be made without consent. An election for a future year could be made only with consent of the Secretary. Also, it was provided that where prepaid income or reserves for estimated expenses were elected, the election would apply to all prepaid income or all estimated expenses attributable to the trade or business with respect to which the election was made.

When the House bill was before the Senate Finance Committee, a representative of the American Institute of Accountants stated in public hearings that certain restraints should be employed in the transition period. He recommended that the impact on the revenues in the transition year be minimized by providing that the addition to the reserve for that year should be spread as a deduction over the transition year and the two succeeding years (hearings before the Senate Finance Committee on Tax Revision, p. 1312).

The staff of the joint committee and the Treasury staff recognized that the "doubling up" effect in the transition year might lead to a substantial loss of revenue if the amount and types of the allowable deductions were not properly controlled. Instead of taking the approach suggested by the accountants of spreading the transition effect over three years, the Treasury staff, with the concurrence of the joint committee staff, recommended to the Finance Committee that broad discretion be conferred upon the Secretary of the Treasury to control the deductions allowable under section 462. The Senate Finance Committee agreed to this more restrictive proposal and inserted the words "in the discretion of the Secretary or his delegate" as a limitation in section 462 (a) of the House bill. It was apparently the opinion of the Treasury at that time that this amendment would permit the Treasury regulations to restrict not only the amount of the allowable deduction but also the kinds of items that would be involved. (See testimony of Secretary Humphrey before the Ways and Means Committee on H. R. 4725, pp. 10-11.) It is apparently the opinion of the Treasury Department at the present time, however, that the words "in the discretion of the Secretary" only limit the amount of allowable deductions under section 462 and do not limit the kinds of items for which deduction may be taken. (See testimony of Secretary Humphrey, *supra*, p. 11.)

B. REVENUE ESTIMATES

The estimates on the loss of revenue arising from the accounting changes made by the 1954 Code were made by the Treasury Department. The total revenue loss which the Treasury estimated would be involved in all the accounting changes was \$45 million under the House bill and \$47 million under the amendments made by the Senate Finance Committee. (The additional \$2 million of revenue loss resulting from the Senate Finance Committee's action was attributable to changes made in other accounting provisions.) The principal items of loss, however, involved in the \$47 million estimate arose from sections 452 and 462.

The joint committee staff accepted the Treasury's estimate of the revenue loss involved in the accounting provisions. The staff recognized that a "doubling up" effect was inherent in these sections but in

view of the limited revenue loss apparently involved, did not feel that this was an important consideration. By the time the accounting provisions were being considered by the Finance Committee, it was recognized that a substantially larger loss than originally anticipated might be involved under some constructions of the House version of these provisions. It was believed, however, that the amendment made by the Finance Committee giving the Secretary discretion over both the types of items and the amount for which reserves could be set up would restrict the loss of these provisions to the estimated amount. However, the Secretary of the Treasury has taken the view that his discretion extends only as to the amount and not to the types of items for which reserves may be established.

It also was recognized that the extent of the loss would be largely dependent upon the number of businesses which would shift to the reserve method. It was known that in the case of certain items coming within the provisions, taxpayers were already taking the estimated future expenses or deferring prepaid income under the accrual method of accounting. For example, with regard to the item of vacation pay, it was known that the existing practice of the Internal Revenue Service was to permit the accrual of future vacation pay under certain specified conditions. Similarly, under rulings of the Internal Revenue Service, newspaper and magazine publishers had been permitted in many instances to defer prepaid subscription income.

PART VI. DIGEST OF REARINGS BEFORE SENATE FINANCE COMMITTEE ON H. R. 4725

Hon. George M. Humphrey, Secretary of the Treasury

Secretary Humphrey recommended that sections 452 and 462 be repealed retroactively to their original effective date. He stated that studies made by the Treasury Department indicate that the revenue loss from these provisions will be far in excess of anything contemplated at the time they were enacted. He said that these provisions were not sufficiently limited in their application and that the problem could not be adequately corrected by regulations. He said that the Treasury Department feared that, unless these provisions are repealed, the result will be endless litigation with taxpayers. He indicated that the Treasury had studied many proposals to correct the situation by amendment rather than repeal but that no proposal had been found which would be certain to accomplish the original objective without giving some taxpayers an unintended advantage or producing involved technical problems creating uncertainty and litigation.

In response to questions by committee members, Secretary Humphrey stated that the only situations in which retroactive repeal would work a hardship on taxpayers are where dividend distributions had been made or money had otherwise been spent in reliance on the belief that these provisions would remain in the law. He said there would be no objection to continuing beyond September 15, 1955, the period in which taxpayers would be allowed to make the necessary adjustments required by repeal of these provisions. He indicated that his two major objections to these provisions were the "doubling" up of deductions in the transition year and the belief that these provisions would place a "premium on overestimating" deductible expenses. He said that two of the most important expense items from the standpoint

of revenue loss were repair and maintenance expense and vacation pay. He assured the committee that if these provisions were repealed the Treasury rulings relating to vacation pay would be continued in effect throughout 1955.

J. S. Seidman, American Institute of Accountants

Mr. Seidman stated that recent studies by the American Institute of Accountants indicate that the maximum revenue loss from 1954 returns resulting from sections 452 and 462 is not likely to exceed \$500 million. Of this, \$450 million applies to section 462 and \$50 million applies to section 452. Over \$200 million of this total amount relates to vacation pay which, even under prior law, will represent a revenue reduction over the next few years if the trend of union contracts in respect of vacation pay continues.

He said that these sections made great strides in bringing tax accounting into line with generally accepted accounting principles. He urged that the provisions be retained but that the problem of the revenue loss be alleviated by specifically listing the income and expense items to be affected and that the revenue reduction in the first year be spread over a period of 10 years. He said that when Canada adopted a similar provision in 1953 the transitional revenue loss was spread over a period of 3 years.

Mr. Seidman referred to several hardship cases which would result from retroactive repeal. Among them were situations where taxpayers have made dividend distributions thinking the distributions were out of capital; cases where taxpayers believed they had contributed 90 percent of their income to charity in order to qualify for the unlimited charitable deduction; and problems which will arise in 1956 in regard to vacation-pay deductions.

In referring to the joint committee staff proposal, Mr. Seidman said there were many phases of the proposal that were distinct improvements over the law as presently written. He believed, however, that the staff proposal was on the severe side because the revenue reduction of the transitional year would be deferred until the windup of the business or the windup of the reserve, whichever takes place sooner. He said that even though he felt this plan was severe, he regarded it as preferable to repeal.

Jacquin B. Bierman, J. K. Lasser & Co., New York, N. Y.

Mr. Bierman said that under administrative ruling I. T. 3369, 1940-1 C. B. 46, the Treasury Department permitted income deferral to publishers who had previously used that method of accounting. The subsequent practice has been conflicting and inconsistent. Publishers who had not previously deferred prepaid subscriptions were required to report them in the year of receipt, under the "claim of right" theory. In a few cases the Treasury Department has by ruling permitted a change to the deferral method of reporting income, in which case adjustments were required with the revenue impact generally being spread over a 10-year period.

Since the recent decision in *Beacon Publishing Co. v. Commissioner* (C. A. 10th, 1955) (218 F. 2d 697) holding that prepaid subscription income must be deferred over the period earned, the problem has become more confused than before.

It has been estimated that 95 percent of all subscription income is now reported on a deferral basis. This 95 percent includes income

that is received over the term of the subscription and consequently is reported on a deferred basis because it is received on a deferred basis.

He urged that section 452 be retained in the law so that the remaining 5 percent of subscription income can be reported on a deferred basis. This is particularly important to the small publishers who have been unable to secure consent to use the deferral method.

If section 452 is repealed, Mr. Bierman said that it is vitally important to the publishing industry that it be made clear that repeal will not constitute a disapproval of I. T. 3369 or of any other ruling procedures affecting publishers.

Paul D. Seghers, Federal Tax Forum, Inc., New York, N. Y.

Mr. Seghers stressed the fact that there was no "double" deduction involved in section 462 since that section simply permits deductions to be matched against the income of the proper year. He said that retroactive repeal of sections 452 and 462 would work irreparable damage, not only to those taxpayers who have taken irretrievable steps in reliance upon them, but, much worse, irreparable damage to taxpayer morale and confidence of citizens in the "honor, good faith, and fair dealing of Congress." He believed that retention of section 452 will permit all taxpayers to be treated alike with respect to prepaid income and will correct the inequities which result from the fact that the publishing industry has been allowed to defer prepaid income while other taxpayers generally have not.

He said he recognized the problem of administration involved in the present sections. He suggested, therefore, that these sections be specifically limited to the items listed in the report of the Senate Finance Committee and that the transitional revenue effect be spread over a period of 3 years or more.

Senator Douglas

Data submitted indicates that payments by employers in 1954 were \$3.25 billion to \$4 billion for vacation pay, over \$2 billion for health and welfare, and over \$3 billion for pension plans. Some \$8.25 billion to \$9 billion related to 1 year's employment and a similar amount related to another year's employment could be deducted in 1 year under section 462, with a possible revenue loss of 52 percent, or from \$4.3 billion to \$4.7 billion. Possible similar doubling up of deductions for expenses in many other classifications would indicate a total possible revenue loss much greater than \$4.7 billion. The Treasury cannot be exonerated from blame for "contributory negligence if not worse." There appear to have been "gross errors" by the Treasury.

The estimate of a possible revenue loss of \$5 billion can be reconciled with Mr. Seidman's estimate of \$500 million as being the difference between "ultimate cost" and "present claims."

Sections 452 and 462 should be completely repealed retroactively; the revenue loss would be no less if it were taken "in three bites rather than one."

William J. Grede, National Association of Manufacturers

Senator Douglas' "figures have no relation to the operation of section 462," because health and welfare and pension fund plans do not require reserves for estimated expense. Amounts paid are deductible under other provisions. "No one has suggested" that section 462 be applied to them. Only a part of vacation pay is a deferred expense,

and much of that is now being accrued, so the revenue loss in that area would be far less than Senator Douglas anticipates.

Retroactive taxation of this type is "inherently unsound and unfair." It is not true that taxpayers had notice of repeal; that was not proposed until March 7, 1955, after the books had been closed and financial statements issued in many cases. Burdens and complications "confronting the taxpayers upon repeal would far exceed any which the Treasury Department would endure by their retention." Sections 452 and 462 conform to economic facts; deduction of 2 years' expenses in the transition year is only "the measure of the inequity of prior law;" repeal would give a windfall to the Government. The loss of revenue for fiscal 1955 will not be cured by H. R. 4725; the improved revenue situation does not require recoupment of this loss in fiscal 1956.

There should be: (1) Legislative restriction as to scope, denying reserves for such things as maintenance and repairs; (2) legislative requirement that the books conform; and (3) a stretchout of the extra deduction under section 462 over 5 years, with full allowance of small deductions in the transition year. The dropping out of 1 year's expenses would not be condoned for financial statements; it does not have a rightful place in the tax system.

Senator Bennett's suggestion that taxpayers be given only a limited time to make elections under sections 452 and 462, so they could not choose a year of maximum-tax benefit, appears reasonable.

William Herbert Danne, Chamber of Commerce of the United States

"Revenue considerations do not require the repeal of section 452 standing alone." Section 462 provides for the "bunching up in the year of transition of two proper deductions"—which has occurred many times under other provisions of law, and under I. T. 3956 for vacation pay.

It is proposed: (1) That the revenue loss be spread over a period, perhaps 5 years; (2) the scope should be limited by law or by regulations authorized by law; (3) taxpayers should be permitted to limit their elections to one or more of the allowable types of reserves.

Many taxpayers in "justifiable reliance" on present law have taken irrevocable steps. H. R. 4725 contains some saving provisions, but it does not deal with third-party relationships such as that of the real-estate owner who has accepted advance rentals, the corporation which has declared dividends, perhaps out of capital, or made other commitments, or the contractor who has made irrevocable penalty-type contracts.

Thomas L. Preston, the Association of American Railroads

In the case of railroads no abuse under section 452 or 462 could occur because their accounts are regulated by ICC. Repeal "would result in serious injustice to the railroad industry." Most are now accruing vacation pay under I. T. 3956, which is to have no effect, under a ruling of the Internal Revenue Service, after 1955. Thus repeal of section 462 (the equivalent of I. T. 3956 in this area) might result in the railroads being "deprived of any deduction whatever in 1 year (1956) on account of vacation pay." Railroads are now required to accrue liabilities for personal injuries and freight loss and damage; section 462 merely conforms tax returns with their books.

It is proposed: (1) That sections 452 and 462 be left unchanged as they apply to railroads; or, (2) if revenue considerations are important, spread the loss over a period of years; and (3) restrict the application to the specific items set forth in the report of the Committee on Finance.

Although the revenue effect overall of retaining section 462 for the railroads would be "only a fraction of the estimates you have heard," for some railroads the tax saving might be substantial, so that stockholders in those railroads may have taken positions they might not otherwise have taken.

Edward M. Fuller, American Cotton Manufacturers Institute, Inc.

"Everybody recognizes that for many years past taxpayers on the accrual basis have been paying taxes on fictitious income." Sections 452 and 462 corrected that evil. "Retrocative repeal at this late date would only compound inequities and throw corporate financing and accounting into a turmoil."

The proposal is: (1) A stretchout of 3 years, or "even up to 10 years"; (2) application of section 462 only to vacation pay, sales returns and allowances and related repayments of commissions, freight allowances, product warranties and guaranties (up to 5 years), cash and quantity discounts, and discounts for anticipation.

The staff proposal (1) "amounts to the disallowance of a deduction for expenses actually incurred"—a stretchout is better; and (2) it does not include reserves for sales returns and allowances, which "are properly accruable, fairly ascertainable, and should also be included."

Examples of hardship cases which would result from repeal are: (1) The Dan River Mills, which has entered upon "plans for machinery and equipment, modernization for the retirement of preferred stocks, and compliance with requirements of our long-term debt agreement, based upon cash forecasts which took into account the provisions of section 462"; and (2) another large company which abandoned litigation resulting from a disallowed accrual of vacation pay in a prior year because "section 462 has now taken care of the situation."

Robert A. Seidel, Radio Corp. of America and RCA Service Co., Inc.

RCA has a greater financial stake in section 462, but that involves a great deal of revenue and may be susceptible of abuse. Section 452, however, corrects hardship resulting from "severe discrimination" in a small area; involves little revenues; is not susceptible of abuse. RCA, and "a large number of other service companies" are taxed when television service contracts are sold, although the services and resulting expenses occur in a later year. "We couldn't sleep at night" if we kept our books that way. By administrative rulings publishers are taxed on subscription income only as the magazines or newspapers are delivered. Section 452 was a "long overdue correction of inequity." Repeal of section 452 will not hurt publishers, although "over \$50 million in revenue" is involved, because Secretary Humphrey's letter of March 22 said he would not change the prior rulings.

The staff proposal would extend to all publishers, to landlords, and to the automobile clubs, the same realistic treatment now accorded to some publishers, thus "magnifying the discrimination" against TV servicemen. TV service contracts are to be covered under a "greatly

watered-down" version of section 462 which would involve no tax relief for 1954. "Why not take care of the publishers, the landlords, and the automobile clubs under section 462?"

The Treasury's position is untenable. Unless this committee recognizes the "clear-cut case of equity involved" we may have no alternative but to contest it in the Tax Court.

"We, and hundreds of smaller service companies, have been hurt." Capital commitments for 1955 have been made on the basis of relief under section 452; repeal "could conceivably put some of the smaller service organizations out of business."

Fleming Bomar, American Automobile Association

Automobile clubs are taxed, although they are nonprofit organizations without stockholders. Substantially all the income is dues paid in advance. If we sold a membership on December 1, 1954, for \$12 our true income for that month was \$1 less 95 cents or 5 cents, yet we are taxed on \$11.05 in 1954 with a deduction of \$10.45 in 1955. Some automobile clubs have been reporting income as earned for tax purposes, others have been denied this method, others in litigation. Repeal of section 452 would result in "rank discrimination, further litigation and utter confusion."

The staff plan as to section 452 is approved, with all its details. By limiting the categories to which it applies section 452 cannot be used as a substitute for section 462; section 452, as thus modified, could be retained even if section 462 were repealed. Other categories could be included in future years, if necessary, and present administrative rules as to all categories should not be disturbed.

Section 462 is also correct in principle, but the difficulties with tax are far greater. The revenue loss under section 452, if modified, would probably be not more than \$15 to \$20 million—less than \$5 million with respect to auto clubs.

Chester M. Edelmann, American Retail Federation

There are about 1.8 million retail stores; gross receipts average less than \$100,000. For many years taxpayers were "unfairly and unjustly taxed on income not earned." Sections 452 and 462 corrected the injustices of the past. The taxpayer was knowingly permitted to deduct in 1954 what he had not deducted in the past and knowingly permitted to deduct in the same year a reasonable amount of future expenses. Repeal would cure a headache by cutting off the head. "What shall it profit the Treasury to gain \$500 million and lose the respect and confidence of the American taxpayer?"

It is proposed that: (1) The items under section 462 be limited to those mentioned in committee reports; (2) taxpayers be permitted to choose section 462 for one or more of the categories; (3) the books should conform; and (4) the revenue loss should be "stretched out" over 5 years for the largest amounts, graduated from 1 to 4 years for smaller amounts.

Charles W. Tye, National Association of Insurance Agents

There are over 32,000 casualty and fire insurance agencies-proprietors, partnerships, and corporations. Under the rule of *Brown v. Helvering* these agencies must be taxed on commissions as received, even though a portion must be refunded if the policy is canceled, and in many cases services—reports, handling of loss claims, changes in

coverage—must be performed during future years. The agency may be placed in an abnormally high tax bracket in the year a large commission is received, and in an abnormally low bracket in a subsequent year.

Proposals were: (1) That agencies be permitted to choose either section 452 or section 462; (2) that the “immediate” revenue loss be reduced by “appropriate amendments”; and (3) that the items qualifying under sections 452 and 462 be specified.

Charles W. Stewart, Jr., Machinery and Allied Products Institute

Congress recognized, as to section 462, that “in the first year of transition there was and should be a double deduction.” Such double deductions, or double taxes in the case of accelerated corporate tax payments, have frequently occurred during transition periods. Taxpayers acted in good faith, had no advance notice of the probability of repeal. Management decisions have been made which probably would have been changed if repeal was expected. Repeal would generate uncertainty which would prevent future firm decisions based on tax law.

Proposals were: (1) That the application be limited to the categories given in committee reports; (2) spread the revenue loss over a 3-year period, or longer; (3) permit the use of these sections for one or a few categories instead of all; and (4) permit elections in years after 1954.

Francis R. Cowley, Magazine Publishers Association

Under administrative rulings 95 percent of the publishing industry was accounting for subscription income for tax purposes as it was earned. Section 452 provided for universal recognition of such correct accounting and economics. If section 452 were repealed the 95 percent have been assured by the Secretary that they could revert back to their former tax practices, so they would not be hurt. But the other 5 percent would be placed in a “highly inequitable position.” I. T. 3369 permitted those who had used the correct method prior to 1940 to continue, but others were denied its use. “It is grossly unjust, grossly discriminatory, and possibly unconstitutional, to segregate taxpayers by date.” Corporation tax collections for March 1955 were \$383 million in excess of estimates; thus the reason given for repeal is “unfounded.”

Sections 452 and 462 should not be repealed, since it is possible to narrow their application consistent with the original congressional intent. If section 452 is repealed, the 95 percent should be assured the right to continue their present tax practices.

Harman E. Snoke, Manufacturers Association of Bridgeport

Retroactive repeal would work an undue hardship on many businesses which adopted in good faith the accounting practices prescribed; it could establish a bad precedent; it would involve “serious legal, ethical, and moral consideration.”

Repeal of section 462 would “reduce immediately by \$300,000 the working capital of one company. Another company will have underestimated its taxes by some \$60,000, and as a result will have to prepare a new financial statement and pay an additional amount to the trustees of its profit sharing plan. Another company would be liable for repayment of \$475,000 in taxes. The financial statements already distributed to stockholders would be altered materially, so that the confidence of its stockholders in the management “might be seriously shaken.”

Proposal: Retain sections 452 and 462, requiring the Secretary to “prescribe regulations which will implement the original intent of Congress.”

APPENDIX A

HISTORY OF TREASURY RULINGS AND COURT DECISIONS ON VACATION PAY ACCRUALS

Under section 43 of the 1939 code, the period for taking deductions was stated to be the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting used in computing net income "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

The regulations under this section of the 1939 code provided that the expenses and liabilities of 1 year could not be used to reduce the income of a subsequent year and that each year's return, so far as practicable, should be complete in itself. The regulations recognized, however, that in any going business there would be certain overlapping items, both of income and deduction. The regulations provided that the taxpayer's consistent treatment of these overlapping items should be allowed so long as income was not materially distorted.

Under an early unpublished ruling, the Internal Revenue Service held that a taxpayer could accrue and deduct as of December 31, 1943, amounts which represented a reasonable estimate of vacation payments to be made in 1944. In that case, an agreement with employees provided that the employees were entitled to receive vacation pay during the year subsequent to the qualifying period, and that they would receive a lump sum if no vacation was actually taken. The vacation pay was computable at the wage rate in effect at time of payment. The Service ruled that there was a definite liability for the vacation pay as of December 31, 1943, even though the exact amount of the liability was not definitely fixed at that time. The ruling relied upon earlier court decisions holding that an item might be properly accrued even though the amount was not definitely fixed. (*Continental Tie and Repair Company* (286 U. S. 290); *Lucas v. American Code Company*, (280 U. S. 445); *Fawcett Machine Company* (282 U. S. 375).)

This unpublished ruling was the basis for subsequent published rulings which allowed the accrual of vacation pay for the subsequent year under similar circumstances. (G. C. M. 25261, 1947 C. B. p. 44; I. T. 3956, 1949 C. B. p. 78.)

The effect of these rulings was that vacation pay for the subsequent year could be accrued as of the close of the taxable year in which the qualifying services were rendered where an employment contract provided that all of the events necessary to fix the liability of the taxpayer for vacation pay had occurred by the close of the taxable year. However, the fact that the employee's right to a vacation (or payment in lieu of vacation) in the subsequent year might be cut off if his employment terminated prior to the scheduled vacation period was not regarded as rendering the liability a contingent one. It was

held that the liability was not contingent since the employer could expect that the employees as a group would receive the vacation pay and that only the ultimate amount of the liability to the group remained uncertain as of the close of the taxable year. In this manner the rulings avoided the effect of the Supreme Court decision in *Brown v. Helvering* (291 U. S. 193) holding that where it was uncertain whether any liability existed, an item could not be accrued for tax purposes until the contingency disappeared and the liability became fixed and certain. These rulings recognized that the employer received a tax benefit in the year he shifted to accruing vacation pay since the employer was entitled to deduct vacation payments actually made in that year, as well as the accrued vacation pay for the subsequent year.

In *Tennessee Consolidated Coal Company* (15 T. C. 424), it was held that the taxpayer could not accrue monthly deductions for vacation payments under a liability imposed by a union contract. In that case the taxpayer filed his returns on a calendar year basis and the period of qualifying for vacations was 12 months' employment prior to June 1. The Tax Court held that liability for vacation pay could not be determined until immediately prior to June 1 of the following year since only employees on the payroll at that time were entitled to vacation pay. It was indicated that the employer's liability might be decreased by the possibility of strikes or increased by probability of vacation pay.

This position was followed in subsequent decision of the Tax Court in *Morrisdale Coal Mining Company* (19 T. C. 208) and in *E. H. Sheldon & Company* (19 T. C. 481). In the *Sheldon* case it was indicated that allowance for the deduction for the taxable year would distort income by deducting from the income of that year vacation pay for 20 months and that it would permit deduction of a contingent liability which would not accrue in the taxable year. The Tax Court's holding in the *Sheldon* case was affirmed by the Court of Appeals for the Sixth Circuit (214 F. 2d 655, July 27, 1954).

In Revenue Ruling 54-608 (December 20, 1954, I. R. B. No. 51), the Internal Revenue Service reconsidered its previous rulings on vacation pay. It revoked I. T. 3956 and modified G. C. M. 25261, on the basis of the Tax Court's decision in *Tennessee Consolidated Coal Company*, *Morrisdale Coal Mining Company*, *E. H. Sheldon & Company*, and the Circuit Court's decision affirming the Tax Court in the *Sheldon* case.

It was held in Revenue Ruling 54-608 that no accrual of vacation pay could occur until the fact of liability to a specified employee was clearly established and the amount of the liability to each individual employee was capable of computation with reasonable accuracy. This ruling was made applicable, however, only to taxable years to which the 1954 code applies, so that taxpayers desiring to accrue vacation pay would be required under Revenue Ruling 54-608 to utilize section 462 of the 1954 code. Since under the proposed Treasury regulations on section 462 taxpayers were given until June 30, 1955, to elect without consent the reserve method under section 462, Revenue Ruling 54-608 was extended (see I. R. B. February 7, 1954, page 6.), so that it would take effect only for taxable years ending on or after June 30, 1955. In other words, for taxable years ending prior to that date, the more liberal Treasury rulings (I. T.

3956, etc.), permitting the accrual of vacation pay were continued in effect.

In a letter to the Ways and Means Committee during the consideration of H. R. 4725, the Secretary of the Treasury stated to the committee that Revenue Ruling 54-608 would be applicable only to taxable years ending after December 31, 1955. Thus, the more liberal Treasury rulings (I. T. 3956, etc.), permitting the accrual of vacation pay are continued in effect under the announced Treasury policy for taxable years ending on or before December 31, 1955.



